IFS VIEWS ON GHANA'S 2016 SUPPLEMENTARY BUDGET

11th August, 2016

On Monday, July 25, 2016, Ghana's Finance Minister, Hon. Seth Terkper, reviewed the 2016 budget and requested Parliament's approval for supplementary estimates of GH₵1,888.2 million for the 2016 financial year.

Below are summary points from the presentation, and our observations.

Summary Points of Presentation

- Estimated real GDP growth for 2016 has been lowered to 4.1 percent from the initial target of 5.4 percent. Non-oil real GDP growth was also revised downwards to 4.6 percent from 5.2 percent. Of the other key macroeconomic targets for 2016, the fiscal deficit to GDP ratio was revised, but no changes were announced to the inflation and gross international reserves targets (10.1 percent and 3 months of import cover respectively).

- Total revenue and grants and total expenditure for 2016 have each been revised downwards by GH₵148.7 million to GH₵37.9 billion (22.7 percent of GDP) and GH₵46.3 billion (27.7 percent) respectively. While this leaves the overall deficit unchanged at GH₵8.4 billion, an upward revision to the estimated 2016 nominal GDP means that the projected deficit is now equivalent to 5 percent of GDP instead of the original 5.3 percent.

- The deficit-financing mix for 2016 has been altered, with net domestic financing increased by GH₵1.2 billion and net foreign financing cut by the same amount. This raises the proportion of net domestic financing to 73.4 percent, with net foreign financing accounting for 26.6 percent. Of the expected domestic financing, an amount of GH₵1.4 billion has been indicated as Bank of Ghana financing, compared with a target of zero, while the Ghana Petroleum Funds will supply net financing of GH₵71.8 million. The net foreign financing includes a sovereign bond issuance of GH₵2.93 billion (about US$750 million).

- Debt amortization has been revised upwards by GH₵2,036.9 million to GH₵5,701.0 million, leading to a request for a supplementary budget of GH₵1,888.2 million, reflecting the additional amortization minus the shortfall in revenue and grants.

- Ghana's public debt increased from GH₵100.2 billion as at end-December 2015 to GH₵105.2 billion at the end of May 2016. The ratio to GDP however fell from 71.6 percent to 63.1 percent in the same period, again as a result of the significant upward revision in the GDP figure for the year.

Our Observations

The Macroeconomy and Growth

1. The sharp revision to the 2016 real GDP growth estimate from 5.4 percent to 4.1 percent is both surprising and worrying as it suggests that, contrary to expectations of a strong pick-up this year, economic growth will remain subdued and well below the average of 7-8 percent before the onset of the recent economic challenges. The economy also continues to experience high inflation, which ranged between 18.4 and 19.2 percent in the first half of the year and has been eroding real incomes. Although the government appears to have stuck to its end-year inflation target of 10.1 percent, the mid-year budget failed to indicate how that target could be plausibly attained during the second half of the year. The high inflation, tight central bank policy stance, and high level of government activity in the debt market have kept interest rates at elevated levels, despite a slight dip at the short end of the market over the past year. Within the banking sector, the average lending rate has increased from 26.9 percent in December 2015 to 32.1 percent in April 2016, with credit growth slowing down considerably amid a swelling stock of non-performing loans. External sector trends have also not been favourable, with the trade and current account balances weighed down by declining export earnings, once again underlining the country's vulnerability to international commodity price swings. The exchange rate meanwhile has been relatively stable since the last quarter of 2015, although the effect on inflation remains muted. Its outlook, however, has become a bit more uncertain owing to the abortive Eurobond issuance.

Fiscal Management

2. The revised budget projects total revenue and grants to fall, relative to 2015, by 0.2 percent of GDP to 22.7 percent of GDP and total expenditure (including arrears clearance and tax refunds) to be cut by 1.5 percent of GDP to 27.7 percent of GDP. This implies that the additional fiscal consolidation envisaged in 2016 relies disproportionately on expenditure under the revised budget, whereas the original budget had forecast a greater reliance on revenue.

3. With regard to expenditure, the revisions entail reductions to capital expenditure, goods and services, and compensation of employees compared with the original budget. This will be offset by increased transfers to other government units, in particular to the Road Fund. At least two issues emanate from these proposed adjustments. The first concerns the feasibility of reducing compensation of employees expenditure through cutting social security payments without incurring arrears, as the government has committed itself to under the IMF program. Social security payments are a given fraction of wages and salaries expenditure, so a cut to this expenditure in the face of unchanged wages and salaries expenditure implies creation of new arrears. The second concerns the rationale for the reduction in capital expenditure, which underpins long-term economic growth. In actual fact, the revised budget proposal will see capital expenditure slashed by GH₵740.5 million (10.4 percent) from 2015, which will take it down to 3.8 percent of GDP from 5.1 percent last year. As we have stated previously,

sacrificing much-needed capital expenditure on the altar of fiscal consolidation may do more harm than good to the economy in the long term.

4. Based on the budget's accounting convention, the supplementary budget request of GH₵1,888.2 million for amortization will be deficit-neutral. Nevertheless, it will lead to an increase in the gross budget financing requirements and thus require more borrowing, on a gross basis, by the government. In the present context of high domestic and external borrowing costs facing the government, the risk in borrowing for amortization or to refinance maturing debt is that the new debt could be procured at a higher interest rate than the one being replaced, leading to a net increase in interest payments on the debt stock.

5. Another issue with the planned amortization involving the buying back of the 2007 Eurobond is that, whereas until now the government has said it is using proceeds from issues of Eurobonds to retire more expensive domestic debt, it is now going to resort to higher domestic borrowing as a consequence of buying back the 2007 Eurobond. The question to ask is whether the implications of this action for domestic interest rates, inflation and real GDP growth have been properly considered.

6. Again with respect to amortization, we have taken note of the fact that just as in the 2016 supplementary budget, the 2015 supplementary budget request was also based entirely on amortization, which was increased at the time by GH₵1.8 billion. However, the 2015 fiscal outturn shows that not a single cedi of the additional money approved was spent on amortization. In fact, the amount actually spent on amortization was GH₵65 million less than even the original budget estimate. Given the loose control over expenditure virement in Ghana, we worry that the requested supplementary budget for amortization could well end up being spent on other unapproved areas.

7. We also find it curious that an amount of GH₵1.4 billion has been apparently indicated as financing from the Bank of Ghana, as against the IMF's continuous condition of zero central bank financing in 2016. While the view of the IFS has always been that abolishing central bank lending to the government is ill-advised, we are not aware of any change to the zero financing condition under the IMF program. And if the central bank is to provide financing to the government, where does this leave the IMF program?

8. We also observe that a large discrepancy figure of GH₵1.7 billion, which has a negative sign and adds to expenditure and the deficit, was recorded in the January-May 2016 fiscal data. In the light of the government's financial management reforms, particularly the deployment of the Ghana Integrated Financial Management Information System (GIFMIS) within the public sector, a discrepancy figure of such large magnitude is puzzling.

9. We would also like to point out that arrears payments have become a major driver of government expenditure in recent years, and that despite successive budgets allocating substantial sums for arrears clearance, huge payments continue to recur. In 2016, GH₵2.3

billion has been budgeted for arrears payments, after payments of GH₵4.1 billion in 2014 and GH₵2.4 billion in 2015. Given that information on the stock of arrears is not provided in the budget, it is difficult to make sense of these numbers. Thus to make this aspect of the budget more transparent, and also help monitor compliance by the government with its commitment to zero arrears creation in the IMF program, details of the stock of arrears, its evolution, and the liquidation payments need to be disclosed.

Public Debt

10. The build-up of public debt has been quite rapid in the last four years, with the debt stock growing from GH₵35.1 billion in 2012 to GH₵100.2 billion at the end of 2015 and the debt-to-GDP ratio climbing from 48.4 percent to 71.6 percent in the same period. This has stirred up troubling memories of the past, when an unsustainable rate of debt accumulation drove the nation to seek debt relief by signing on to the Heavily Indebted Poor Countries (HIPC) initiative. The government declared in the supplementary budget that the debt-to-GDP ratio has reversed course, but we think this is inaccurate. This is because the main reason for the fall in the ratio during the year is the effect of the projected large nominal GDP of GH₵166.8 billion in 2016 used to derive the ratio. The upward revision in the nominal GDP figure to this level itself raises some doubts in view of the fact that the projected real GDP growth for the year has been cut down from 5.4 percent to 4.1 percent and there has been no revision to projected inflation. More importantly, it has to be noted that as more borrowing takes place in the remaining period of the year, the debt-to-GDP ratio will certainly rise. A more substantive reduction in the debt burden can thus only be achieved if fiscal consolidation continues, the exchange rate is kept stable, and economic growth strengthens.

11. Moreover, the worries about the debt do not only have to do with the ratio to GDP but also the interest spending on the debt. Interest cost to government has risen from GH₵2.4 billion (3.2 percent of GDP) in 2012 to an estimated GH₵10.5 billion (6.3 percent of GDP) in 2016. Relative to total government expenditure, interest cost has jumped from 9.6 percent in 2012 to a projected 22.7 percent in 2016. In addition, whereas traditionally the budget for debt interest has not exceeded the capital budget in Ghana, the reverse has been occurring since 2014. In that year, interest cost was 16.2 percent more than capital expenditure. The gap increased to 27.2 percent in 2015 and is estimated to be 64.1 percent in 2016. We do not think this situation is tenable. The need to reduce the public debt burden therefore is also to cut back on debt interest payments, which are crowding out public investment and other critical expenditure.

Lower Cap on Stabilization Fund

12. The proposal to further lower the cap on the Ghana Stabilization Fund to US$100 million is disturbing since it risks undermining the objective for creating the Fund, which is to build savings to cushion the impact on the budget of unanticipated shortfalls in petroleum revenues.

The continued depletion of the Stabilization Fund, whose closing book value at the end of 2015 was just US$177.4 million, weakens its capacity to help sustain critical public expenditure when oil prices decline. It also has the propensity to cause more borrowing by the government to plug revenue shortfalls.

Conclusions and Recommendations

13. In conclusion, it is our view that the supplementary budget gives scant assurance that the weak economic conditions that have prevailed for quite some time in the country will be mitigated during the remaining period of 2016. The trend of weak economic growth, high inflation, high interest rates and debt unsustainability has not been reversed, and debt vulnerability could worsen as the government contemplates more external borrowing at an expensive cost. We think it is necessary for the government to re-examine its borrowing plans for 2016, with the view to limiting the interest cost burden and debt distress risks. Finally, the real sector needs far greater attention than it has been given in current economic policies. This is because the current weak economic growth does not provide a good context for the further fiscal consolidation envisaged by the government.